



**Statement
of
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&
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of the
National Association
of
Small Business Investment Companies**

**Before The
United States Senate
Committee on Small Business & Entrepreneurship**

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Madam Chair, Senator Kerry, and members of the Committee:

I appreciate the opportunity to testify today on behalf of the National Association of Small Business Investment Companies (NASBIC) regarding the Small Business Investment Company (SBIC) program in general and S. 1923 in particular. NASBIC is the professional association dedicated to representing the interests of all licensed SBICs. We hope our views are helpful to the Committee as you consider the issues we will address today.

By way of background, I am the Managing Director of North Atlantic Capital in Portland, ME. I am also a member of the Board of Governors of NASBIC and serve as President of NASBIC's northeast regional association. A more complete statement of my background is attached.

North Atlantic Capital manages two Participating Security SBICs focused on providing equity capital to Northeast businesses that require growth capital in the \$2 million to \$5 million range. We pride ourselves on our ability to provide unique services to the small business we fund. For example, every year we take all of our CEOs to a leading business school for management and leadership training. In addition, we offer tactical and strategic consulting services to our companies to help them grow to a new level. All of these services are provided free of charge to the small businesses—our objective is to help them grow and prosper. A good example of one of our investments is Diamond Phoenix Corporation of Lewiston, ME, a leader in providing integrated material handling equipment, software, and control technology for order fulfillment systems. We first invested in the company in 1998 and have invested a total of \$4.0 million over seven years. I am pleased to say that our investments have been instrumental in helping the company grow to its current size—120 employees—and to weather the recent recession. In just the past year, revenues have nearly doubled, and profitability has soared. Diamond Phoenix has eight offices in eight different states as well as an office in London, England.

By way of background, there are currently 403 active SBICs: 178 Participating Security SBICs (designed to provide equity capital to U.S. small businesses); 128 Debenture SBICs (designed primarily to provide subordinated debt financing to small firms); 72 unleveraged bank SBICs (a subset of SBICs substantially reduced in importance since the passage of the Gramm-Leach-Bliley Act in 1999); and 25 SSBICs (100% minority focused debt providers “grandfathered” under the provisions of the 1996 legislation that closed the program to new licensees). By far the most important SBICs in terms of dollars invested in small businesses are the Participating Security SBICs and the Debenture SBICs. Of the \$2.9 billion invested by SBICs in 2,299 small businesses in FY 2005, Participating Security SBICs invested \$1.6 billion (55%) and Debenture SBICs invested \$1.1 billion (38%). Together they accounted 93% of all dollars invested. Bank SBICs accounted for slightly over 6% of dollars invested and SSBICs accounted for the remaining 1% of the total. Participating Security and Debenture SBICs are on track to invest similar amounts in FY 2006; Bank SBICs and SSBICs will likely invest less than last year. Additional information about the SBIC program is attached as an appendix to this testimony.

Although I will address all major SBIC issues, my focus today will be on S. 1923, the “Small Business Investment and Growth Act of 2005.” We appreciate the growing support for the bill and believe its passage would correct structural issues related to the Federal Credit Reform Act and program performance that have caused the effect lapse of the Participating Security program.

A. The Status of the Debenture SBIC Program

1. The Debenture SBIC program is very stable at present. It enjoys the strong support of both the Administration and Congress. The 128 active Debenture SBICs manage a total of \$4.9 billion in total committed capital resources. There were 11 new Debenture funds licensed in FY 2005 and SBA anticipates licensing as many as 15 new Debenture SBICs this fiscal year, FY 2006. The subsidy rate remains at “zero” and has required almost no adjustment in fees or interest paid by Debenture funds over the past two years to maintain that rate. Given the situation with respect to the Participating Security program, the Debenture SBIC program has represented the only real opportunity to increase the impact of the SBIC program with respect to future investments in U.S. small businesses.
2. The Administration has proposed \$3 billion in new leverage availability for the Debenture SBIC program in its FY 2007 budget submission. Based on current and projected usage, that will meet the needs of existing and new Debenture SBICs through the end of FY 2007. NASBIC supports the Administration’s proposal for FY 2007 Debenture leverage availability.
3. Where we part company with the Administration is on its proposal to charge Debenture SBICs substantial fees to subsidize SBA administrative costs. The proposal is vague and even SBA has been unable to tell us the particulars of the Administration’s proposal. For example, the budget submission states that a 0.64% fee would be charged on all “loans” over \$1.0 million. SBA has subsequently said that the fee would apply to “commitments.” Commitments are not loans. However, if the proposed fee were to apply to all commitments (it being difficult to believe the Administration would allow SBICs to divide all their commitments in to sub-\$1.0 million pieces), an averaged size Debenture fund would pay approximately \$256,000 in fees over the life of the fund. That is a significant amount.
4. Such a change would very unfair to existing SBICs. When they raised money to start their funds, their investors knew there would be a subsidy rate risk and a credit risk. However, they were not told there would be a risk that the SBIC would have to fund part of the administrative cost structure of SBA—in a way that would also increase the SBIC’s credit risk. This is different from the 7(a) and 504 programs (with substantially lower proposed fees) where each new loan stands on its own and a borrower can decide whether or not to enter into the transaction at the time the loan is considered. With the SBIC program, the borrower (the SBIC) is locked into an SBA-approved business plan that will run at least 10 years. To unilaterally add a major new category of cost in the middle of the game is unfair at best and a breach of contract at worst.
5. Such a change would also have a substantial negative impact on the formation of new funds. Since fund managers can have no impact on SBA’s administrative budget, the change would introduce a substantial variable cost that cannot be controlled by fund managers. Few investors would be willing to risk million of dollars in a deal with open-ended costs (SBA says they want to pass all fully loaded administrative costs on to the borrowers) that cannot be quantified. The proposed fees would reduce substantially the

number of fund managers and investors who would be willing to apply for a new Debenture license. Small businesses would suffer accordingly. NASBIC strongly opposes the Administration's fee proposal.

B. The Status of the Participating Security SBIC Program

1. The Participating Security SBIC program has been closed to new licensees for two years; the last new funds were licensed in FY 2004. The program will ramp out of existence if no legislative action is taken to save or restructure the program.
2. The need for the Participating Security program has been confirmed by several independent sources over the past 18 months. The Center for Private Equity and Entrepreneurship at Dartmouth's Tuck School of Business confirmed the need in a study dated July 9, 2005. Daniel O'Connell, the director of the Golder Center for Private Equity within the College of Business at the University of Illinois confirmed the need for the program in testimony before the House Small Business Committee on April 13, 2005. Susan Preston, an expert on angel investing and Entrepreneur-in-Residence at the Ewing Marion Kauffman Foundation confirmed the need for the program at that same hearing, as did two CEO's of SBIC-financed small businesses. Finally, the National Venture Capital Association confirmed the need for the program in its September 9, 2004 letter to President Bush. I will submit copies of these documents for the hearing record.
3. Faced with this evidence of need for a program that stimulates equity investments in small businesses that are not served by the non-SBIC venture capital industry, the Bush Administration has elected to ignore it; to pretend it does not exist. The Administration has said "there is no demonstrated need" for such a program, that they are aware of no studies that support the need, and that SBA loan programs are sufficient to meet any existing small business venture capital needs. It will be for this Committee to make the ultimate determination as to whether or not the Administration's position is correct.
4. Assuming a need for the program to stimulate equity investments in U.S. small businesses, the question becomes how to restart the flow of capital. No new Participating Security licenses have been issued since FY 2004 for two primary reasons. First and foremost, the Administration has made the determination that the implementing legislation for the program does not meet the requirements of the Federal Credit Reform Act (FCRA) for a credit subsidy program eligible for credit scoring that offsets current costs with estimated future revenues. Without that qualification, an appropriation equal to 100% of any desired program level would be required on an annual basis. Clearly that would be a non-starter for the Participating Security program, or any SBA finance program. The second reason is that an unacceptably high subsidy rate would apply to any new Participating Security leverage even if the program met the requirements of the FCRA—a rate attributable to both structural defects in the program and losses attributable to the recent recession.
5. The reason given by the Administration for the non-qualification with FCRA was that the Administration considers Participating Securities "equity" securities, notwithstanding the

fact that the Administration requires Participating Security SBIC to carry those securities on their financial statements as Debt. Qualifying FCRA securities must be “debt” securities. Thus, for the past two years the industry and the House and Senate committees on small business have tried to design legislation that would pass muster with the Administration’s definition of “debt” securities and adjust the “economics” of the program so as to merit a “zero” subsidy rate. The most recent efforts are represented by H.R. 3429 introduced by Mr. Manzullo and S. 1923 introduced by Senator Snowe last year and now pending in the Senate with several co-sponsors. We believe the Administration had agreed that both bills meet the requirements of the Federal Credit Reform Act for the purposes of being eligible for credit scoring in the appropriations process.

6. However, meeting the requirements of the Federal Credit Reform Act is only the first hurdle. The legislation must score at a “zero” subsidy rate to have any chance of being a meaningful program in terms of economic impact. SBA’s 504 and 7(a) loan programs and the Debenture SBIC program carry zero subsidy rates and NASBIC supports this requirement for any legislation that would restart an equity investment program. By its terms, S. 1923 would require that fees authorized by the legislation be adjusted annually to maintain a zero subsidy rate.
7. Based on preliminary indications from the Administration, the Administration seems unlikely to score S. 1923 at a zero subsidy rate for the purposes of FY 2007. We believe that scoring is based on unrealistically conservative estimates as to the likely performance of funds that might be licensed if S. 1923 were enacted.
8. However, in order to reach a zero subsidy rate, NASBIC recommends the following change in S. 1923: amend what would be §321(b)(6)—regarding the maximum leverage that would be available to Participating Debenture SBIC—to limit such maximum leverage to 100 percent of the leverageable private capital of a licensed company. Reducing the maximum leverage from 200% to 100% would not only reduce total dollar’s guaranteed by SBA for any one Participating Debenture SBIC, but would reduce the risk of loss substantially by reducing the maximum debt-to-equity ratio from 2:1 to 1:1. Such a change should be more than enough to reduce the subsidy rate to zero under any reasonable set of scoring assumptions.
9. NASBIC has one other recommended change to S. 1923: amend what would be §321(a)(6)(A)(i) of the bill to provide that any accrued interest due on leverage that has not been paid previously be paid on the “seventh anniversary of the issuance of the debenture” rather than on the “fifth anniversary” as provided at present. A deferral period seven years is what is reasonably required to enable Participating Debenture SBICs to make early stage investments in start-up and other very young small businesses. Early stage equity capital is the scarcest form of equity capital and we believe the SBIC program should help address that need. We do not believe the change should have a major impact on the subsidy rate. The bill still requires accrued interest to be paid whenever the SBIC has any gross receipts as defined in the bill, whether or not within the interest deferral period and irrespective of profitability. In addition, SBA’s rights with

respect to any capital impairment make it unlikely that an SBIC would be able to draw substantial leverage if not performing within the limits set by SBA.

10. To conclude my remarks on S. 1923, NASBIC believes that the legislation is the right approach to restarting the flow of equity venture capital to U.S. small businesses through the SBIC program. We believe the changes we have suggested will improve the bill while at the same time reducing risk of loss to the government. We look forward to working with the Committee and the Administration in the coming weeks to fashion a final bill that will meet the needs of all stakeholders in the program.

C. Additional NASBIC Proposals For The SBA Reauthorization Bill

NASBIC will submit suggested legislative language for each of the following proposals:

1. An extension of the time for the exercise of Participating Security commitments sold to Participating Security SBICs in the years FY 2002, 2003, and 2004 to solve a very serious "commitment expiration" problem for existing Participating Security SBICs.
2. An amendment of §306(a) of the Small Business Investment Act of 1958 to correct what we believe are the unintended results of the formula for calculating the maximum percent of its total capital, including all leverage, that an SBIC can invest in a single small business. The existing formula yield differing percentages depending on the leverage ratio. NASBIC's proposed amendment would create a formula that would be consistent in its application to all SBICs, irrespective of leverage ratios.
3. An amendment of §303(g)(12) of the Small Business Investment Act of 1958 to clarify the rules that apply to distribution of publicly traded, marketable securities held by Participating Security SBICs due to successful portfolio company public stock offerings. The clarification would correct the current situation which has seen SBA unilaterally change the rules applicable to such distribution to the detriment of the program.
4. An amendment of §303(d) of the Small Business Investment Act to require that the Administrator require each licensee, as a condition of an application for leverage, to certify in writing that not less than 25% of the licensee's aggregate dollar amount of financings will be provide to smaller enterprises. This would replace the current requirement that a base of 20% be invested in smaller businesses plus 100% of investments made with leverage in excess of \$90 million. The change would simplify record keeping and administration while increasing the across-the-board requirements for all leveraged SBICs.

In conclusion, thank you for your consideration of our views regarding the current status of the SBIC program and our suggestions for legislative changes that would improve the program and its ability to serve U.S. small businesses across America. We look forward to working with the Committee during the months ahead to further develop our ideas with the hope that they might be included in reauthorization legislation to be passed this year.

The U.S. Small Business Investment Company Program

- The U.S. Small Business Investment Company (SBIC) program was created by Congress in 1958 to help small U.S. businesses meet their requirements for growth and operating capital not available through banks or other private capital sources. Small companies often require financing in the critical \$250,000 to \$5 million range in the form of either subordinated loans not made by banks or equity investments not generally available from non-SBIC private equity firms. SBICs fill that gap—supporting thousands of U.S. small businesses each year.
- The SBIC program is a unique partnership between the public and private sectors. SBICs are private equity funds that invest in U.S. small businesses that meet size and operational criteria set by the federal government. SBICs are licensed and regulated by the U.S. Small Business Administration (SBA), but privately managed by private sector management teams whose qualifications and business plans are approved in advance in a rigorous licensing process. Minimum capital required to start an SBIC—\$5.0 million—must come from qualified private investors. Additional capital—as much as three times the private capital—is then potentially available to each SBIC through SBA by sale of SBA-guaranteed securities on an “as needed” basis to support fund investments and expenses. The private capital is at risk in its entirety before any taxpayer money is at risk, and SBA examines SBICs regularly to ensure their financial soundness and regulatory compliance.
- Since its beginning in 1958, the SBIC program has provided approximately \$46 billion of long-term debt and equity capital to more than 99,000 small U.S. companies, with \$2.9 billion invested in 2,299 small U.S. companies in FY 2005 alone. Many well-known U.S. companies received early financing from SBICs, including Intel, Apple Computer, Callaway Golf, JetBlue Airways, Whole Foods Market, Palm Computing, Staples, Quiznos, Federal Express, Outback Steakhouse, Costco, Mothers Work, and Build-A-Bear Workshop. Eleven of the top 100 companies on the latest *Inc. 500* list of America’s fastest-growing private companies received SBIC financing (November 2005), as did eight of the top 100 “Hot Growth Companies for 2005” featured in *BusinessWeek* (June 6, 2005), three of the nine members of *BusinessWeek*’s “Hot Growth Hall of Fame,” and six of *Fortune* magazine’s “100 Best Companies to Work For” (January 23, 2006).
- More than 40% of all SBIC investment dollars in FY 2005 went to companies that had been in business only three years or less at the time of the investments. SBICs are a crucial source of capital during those difficult early years.
- Small businesses receiving SBIC financing in FY 2005 employed approximately 218,000 individuals—an average of 95 employees per company—at the time they received the SBIC financing. The median number of employees in SBIC-financed companies was 34.
- SBICs play an important role in financing local businesses in states and geographic regions not generally served by non-SBIC private equity firms. Of the 2,299 U.S. small businesses that received FY 2005 SBIC financing, 23% were located in government-designated Low- and Moderate Income (LMI) areas of the country. Those LMI-district companies received \$543 million (19%) of the total \$2.9 billion invested by SBICs in FY 2005.
- SBICs are playing a vital role in our continuing economic recovery from the last recession—especially in the manufacturing sector. Of the \$2.9 billion in SBIC investments in FY 2005, 30% were made in hard-pressed small U.S. manufacturing companies. For the period FY 2001 through FY 2005, SBIC investments in small manufacturing companies totaled \$4.3 billion.

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Mark Morrisette

Mark Morrisette is Managing Director of North Atlantic Capital of Portland, ME. North Atlantic Capital is a venture capital firm led by a team with nearly 50 years of combined investment experience. The firm invests in established and growing companies in the eastern United States with a preference for the Northeast and mid-Atlantic regions. North Atlantic's primary investment focus is on companies using technologies to deliver products and services to their customers. Since 1986, North Atlantic has raised and managed three partnerships (two of them Participating Security Small Business Investment Companies) totaling over \$160 million of committed capital, has invested in more than 57 businesses, and has generated consistent and strong returns for its investors.

Mr. Morrisette has been in the venture capital industry since 1995 and serves as a Director for several North Atlantic Capital portfolio companies. He is a member of the Board of governors of the National Association of Small Business Investment Companies and President of that organization's northeast regional association. Prior to joining North Atlantic Capital in 2000, he worked at Advent International in Boston, and in consulting at CSC Index in Cambridge, MA. He earned a BA from Dartmouth College and an MBA from Harvard Business School.